No. 17507-8-9

United States Court of Appeals
For the Ninth Circuit

MAX KUNEY, JR. and CONSTANCE K. KUNEY, His Wife;
MAX J. KUNEY, SR., OLIVE R. KUNEY, *Appellants,*

vs.

WILLIAM E. FRANK, District Director of Internal Revenue, *Appellee.*

ON APPEAL FROM THE JUDGMENT OF THE UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF WASHINGTON

BRIEF FOR THE APPELLANTS

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BRIEF FOR THE APPELLANTS

OPINION BELOW

The instructions to the jury (R. 332-352) and their verdict (R. 77-78), are reported at 61 U.S.T.C. 9223. The District Court's memorandum decision and memorandum opinion are at R. 48-49 and R. 353-357, respectively.

JURISDICTION

This appeal involves Federal income taxes and interest thereon paid by Appellants to Appellee for the calendar years 1952, 1953 and 1954.

Appellants filed timely Federal income tax returns for the years 1952, 1953 and 1954 and paid the taxes shown due thereon. Thereafter, the Commissioner of Internal Revenue assessed additional income taxes and interest against Appellants, which amounts were paid. Claims for refund were filed by Appellants, within the

time provided in Sec. 7422 of the Internal Revenue Code of 1954. On February 10, 1960, Appellants brought these actions in the United States District Court for the recovery of $45,953.71, $22,823.10, and $14,290.47, together with interest as provided by law, and costs of the actions. Jurisdiction was conferred on the District Court by Title 28 U.S.C. 1340. At the conclusion of the trial of these actions before a jury, a verdict was entered for Appellants. Upon Appellee's motion for judgment notwithstanding the verdict, the District Court ~~of the jury was~~ reversed the jury's verdict on March 22, 1961. The judgment not~~h~~withstanding the verdict of the jury was thereafter entered on April 25, 1961. Within sixty days thereafter, on May 19, 1961, notices of appeal were filed by Appellants. Jurisdiction is conferred on this Court by Title 28 U.S.C. 1291.

QUESTION PRESENTED

Whether or not the controls retained or exercised by grantors were sufficient under all the facts and circumstances to reverse the verdict of the jury that the trusts were genuine, bona fide and valid partners of the Kuney family partnership for income tax purposes.

SUMMARY OF ARGUMENT

The grantors neither retained nor exercised controls over the trust property other than those necessary to managing partners. The controls retained or exercised by Appellants-grantors were not of the type or degree to allow the District Court to reverse the verdict of the jury that the trusts were genuine, bona fide and valid partners of the Kuney family partnership for income tax purposes.

STATEMENT

The Commissioner of Internal Revenue determined that the income reported by Max J. Kuney, Sr. and Max J. Kuney, Jr., as trustees, for the years 1952, 1953 and 1954, representing a proportionate share of the income earned by Max J. Kuney Company, a family partnership, was attributable to Max J. Kuney, Sr. and Max J. Kuney, Jr. as individuals instead of as trustees.

For each of the years 1952, 1953 and 1954, the Appellants timely filed Federal income tax returns, and timely paid the income taxes indicated thereon. On November 20, 1957, the Commissioner of Internal Revenue determined deficiencies against Appellants for the years 1952, 1953 and 1954, which deficiencies, together with interest thereon, were paid on or about February 5, 1958. Claims for refund were filed by Appellants on the ground that the Max J. Kuney Company was a valid family partnership, consisting of the following (R. 51-53):

1. Max J. Kuney, Sr. and his wife, Olive R. Kuney, as a community (1952 only).
2. Max J. Kuney, Jr. and his wife, Constance K. Kuney, as a community (all years).
3. Max J. Kuney, Jr., as trustee for trust: John R. Kuney.
4. Max J. Kuney, Sr., as trustee for trust: Max J. Kuney III.
5. Max J. Kuney, Sr., as trustee for trust: Caroline I. Kuney.

The claims for refund before the District Court were (R. 53):

Name	*Year*	*Refund*	*Interest*	*Total Claim*
Max J. Kuney, Sr.	1952	$13,343.34	$ 319.05	$13,662.
Max J. Kuney, Sr.	1953	4,149.57	.00	4,149.
Max J. Kuney, Sr.	1954	3,818.48	1,192.66	5,011.
Olive R. Kuney	1952	13,815.48	473.99	14,289.
Max J. Kuney, Jr.	1952	32,740.80	2,336.15	35,076.
and	1953	5,085.09	.00	5,085.
Constance K. Kuney	1954	4,496.32	1,295.35	5,791.
TOTAL		$77,449.08	$5,617.20	$83.066.

The income of the Kuney family partnership prior to allowan
of compensation to managing partners was (R. 54):

Class of Income	*1952*	*1953*	*1954*	*Total*
Ordinary Income	$419,346.59	$85,796.42	$ 55,571.02	$560,714.
Capital Gain	31,078.49	13,807.35	63,352.58	108,238.
TOTAL	$450,425.08	$99,603.77	$118,923.60	$668,952.

The compensation paid by the Kuney partnership to the manag
ing partners was (R. 54):

Name	*1952*	*1953*	*1954*	*Total*
Max J. Kuney, Sr.	$25,000.00	$10,000.00	$ 5,000.00	$40,000.
Max J. Kuney, Jr.	25,000.00	10,000.00	5,000.00	40,000.
TOTAL	$50,000.00	$20,000.00	$10,000.00	$80,000.

It was stipulated that if the jury found for the plaintiffs as to any of the years in controversy, the parties would submit computations to the court of the tax refunds due to the plaintiffs on the basis that after the payment of reasonable salaries to Max J. Kuney, Sr. and Max J. Kuney, Jr., the remaining net profits of the partnership would be divided among the partners as follows:

A. One-half thereof to be paid to Max J. Kuney, Sr. and to Max J. Kuney, Jr., as Trustee for John R. Kuney, to be divided between said two partners in the same ratio as their two capital accounts bore to each other on January first of each year; and

B. One-half thereof to be paid to Max J. Kuney, Jr. and to Max J. Kuney, Sr., as Trustee for Max J. Kuney III and Caroline I. Kuney, to be divided between said two partners in the same ratio as their two capital accounts bore to each other on January first of each year (R. 70).

Max J. Kuney, Sr., born 1894, resides at Seattle, Washington. In 1916 he was married, and from this marriage Max J. Kuney, Jr. was born in 1918. Max J. Kuney, Sr. founded the present construction contracting business in 1930. He made Max J. Kuney, Jr. an equal partner when he became 21 years of age. In 1944 Max J. Kuney, Sr. married Olive R. Kuney, and from this marriage John R. Kuney was born in 1945 (R. 98-101).

Max J. Kuney, Jr. was married to Constance K. Kuney in 1940, and from this marriage Max J. Kuney

III was born in 1942. Caroline I. Kuney was born in 1950.

From earnings partially retained in the business, Max J. Kuney, Sr. and Max J. Kuney, Jr. had respectively $595,000.00 and $485,000.00 invested in the business on December 31, 1951 (R. 106). Max J. Kuney, Sr. was motivated by the natural desire to do for his son, John, then six years old, what he had done for his son, Max J. Kuney, Jr. (R. 108). He was aware that a man 57 years old should not postpone such an important matter for fifteen years until John became of age (R. 108). His desire was that John would become identified with the business of Max J. Kuney Company and be inclined to carry it on after his death (R. 108). He was advised that the only way he could transfer a portion of his partnership interest to a minor child was by placing this interest in trust. He was further advised that he himself could be trustee of such a trust, or that any other trustworthy person could be trustee. He decided that his elder son, Max J. Kuney, Jr., should be trustee because he was a responsible person and the person most capable to manage John's affairs. Furthermore, he hoped this would serve to tie these half-brothers more closely together. He considered, but rejected, naming a bank or trust company as trustee, concluding that such trustee would have insufficient interest in or knowledge of the business of Max J. Kuney Company, and that such an impersonal relationship would tend to defeat the family relationship purpose (R. 109-111). On January 1, 1952, Max J. Kuney, Sr. gave $100,000.00 of his capital interest in the Max J. Kuney Company to Max J. Kuney, Jr., as trustee for the benefit of John R.

Kuney, to be his irrevocably and forever (Plaintiff's Exhibit No. 2, R. 369-381).

Max J. Kuney, Jr., wanted his children to become identified with the business of Max J. Kuney Company and be inclined to carry it on with him, as he himself had done with his father (R. 267). However, he did not seriously consider doing so until he was advised that Congress had enacted a law eliminating any cause for litigation (R. 263). He consulted his attorney, Mr. Witherspoon, several times prior to 1951 concerning this matter. He was also advised that the only way he could transfer a portion of his partnership interest to his minor children would be by placing their interest in trusts. He selected his father as trustee for his children because he was confident that he would not only act for their benefit in a business way, but in a personal way. Furthermore, he was fully qualified to handle the children's interests in the family business (R. 267). Therefore, on January 1, 1952, Max J. Kuney, Jr. gave $50,000.00 of his capital interest in the Max J. Kuney Company to Max J. Kuney, Sr., as trustee for the benefit of Max J. Kuney III and $50,000.00 of his capital interest in the Max J. Kuney Company to Max J. Kuney, Sr., as trustee for the benefit of Caroline I. Kuney, to be theirs irrevocably and forever (Plaintiff's Exhibit No. 1, R. 357-369).

The trust agreements were dated and executed by Max J. Kuney, Sr. and Max J. Kuney, Jr. February 11, 1952. The trusts direct that $100,000.00 of the capital account of Max J. Kuney, Sr. be placed to the credit of Max J. Kuney, Jr. as trustee for John R. Kuney, and

that $100,000.00 of the capital account of Max J. Kuney, Jr. be placed to the credit of Max J. Kuney, Sr. as trustee for Max J. Kuney III and Caroline I. Kuney, in equal amounts. The trusts provide that any or all of the income earned by the trusts may be distributed to the beneficiary by the trustee until the beneficiary reaches the age of 30 years, and that thereafter the income must be distributed by the trustee to the beneficiary. The trusts further provide that the principal may be distributed by the trustee to the beneficiary at any time and in any amounts after the beneficiary reaches the age of 21. Within these limitations the trustee has absolute discretion regarding the distribution of principal and income. The grantors have no reversionary interest in either the income or the principal of the trust. Under the management and investment provisions of the trusts, the trustees may invest any or all of the trust corpus and/or income within the usual permissive limits generally applicable to trustees. Successor trustees are the trust grantors in each case, and thereafter the Seattle-First National Bank (Plaintiff's Exhibits No. 1 and No. 2, R. 357-381).

Appropriate entries were made in the partnership books to reduce the capital of Max J. Kuney, Sr. and Max J. Kuney, Jr. $100,000.00 each and to establish capital accounts for trust: John R. Kuney—$100,000.00; trust: Max J. Kuney III—$50,000.00; and trust: Caroline I. Kuney—$50,000.00 (R. 123).

The grantors filed timely Federal and State gift tax returns for the year 1952 showing their respective gifts of $100,000.00 and paid the gift tax due thereon (R. 54-56).

During each of the years 1952, 1953 and 1954, capital was a material income producing factor in the partnership business (R. 56). During these years cash distributions were made by the trustees to the named beneficiaries of the trusts (R. 56). Timely partnership returns of income were filed to report the income distributed to the partners, and timely fiduciary and personal returns of income were filed to report the income tax payable by the partners (R. 51). During this time the partners reported $729,633.22 income, and after deducting all income tax refunds received, paid $377,959.01 Federal income tax. There has never been any question on the amount of income or the amount of income tax paid (R. 191). Appellants contend that the total Federal income tax properly payable by the partners is $316,444.57, as shown on "Schedule D, Income Tax for Years 1952 through 1954 Computed per Pre-Trial Order." The refundable difference, $61,514.44, is less than the $77,449.08 refunds claimed principally because $77,449.08 includes income taxes which would be payable by the trusts and trust beneficiaries if this amount was refunded to the trusts' grantors (Schedule D, Appendix *infra*).

The parties stipulated that the books and records of Max J. Kuney Company clearly show the interests of the trusts in 1952 and thereafter (R. 131-133).

From January 1, 1952, to May 31, 1953, the trusts were partners in all the Max J. Kuney Company operations. On June 1, 1953, Max J. Kuney, Sr. and Max J. Kuney, Jr. withdrew their interest in the assets of the operating partnership, except their interest in the fixed

assets (land, buildings, machinery and equipment) owned by the partnership.

At this time Max J. Kuney, Sr. and Max J. Kuney, Jr. formed the Max J. Kuney Company Corporation. Each invested $200,000.00 in its capital stock and $258,443.34 and $128,849.30 respectively in paid in or capital surplus in Max J. Kuney Company Corporation, as shown on Schedule A (Appendix *infra*). This corporation owned all the assets of the former partnership except the fixed assets, which were retained by the Kuney family partnership. The book value of the Kuney family partnership assets was then $504,033.72, corrected to the basis of January 1, 1954, as shown on Schedule B, Summary of Partners' Capital Accounts and Income Distribution (Per Cent) January 1, 1952 through December 31, 1958 (Appendix *infra*). The effect of this reorganization was to remove the trusts capital from a large business where their total share was less than 19 per cent and place it in a smaller business where their share was approximately 45 per cent, as shown on Schedule B. This reorganization also removed the trust capital from the hazards and fluctuating income inherent in construction contracting and placed it solely in fixed assets, from which a safe and steady income could be received. Such ownership is far more acceptable to trustees in general (R. 27).

The formation of the Max J. Kuney Corporation accomplished a further purpose planned for several years. It permitted the investment of $100,000 by the former partnership's General Superintendent and its Office Manager where $100,000 would give them 20 per

cent interest in $500,000 total capital stock of the operating corporation (R. 126 and R. 270).

After the formation of the operating corporation on June 1, 1953, the sole business of the Kuney family partnership has been to buy and sell fixed assets as business circumstances required, and rent them to the operating corporation (R. 127). The compensation paid by the Kuney partnership to the managing partners was adjusted accordingly (R. 128-129).

The partnership agreements of February 11, 1952 (Exhibits 24 and 25) provide that partnership income shall be distributed annually "as provided by the rules of law then effective for family partnerships . . .". The evidence shows that Max J. Kuney, Sr. and Max J. Kuney, Jr. in their capacities as grantors, trustees, and partners did at all times direct that these rules be strictly observed.

The three trusts started with $200,000.00 capital January 1, 1952. Retained earnings increased this amount to $260,820.48 December 31, 1954, and to $405,958.34 December 31, 1958. The increase for each trust was slightly more than 100% over the course of seven years. The three trusts' total capital December 31, 1960, is $475,456.44. Schedules A and B show a steady, consistent increase in trust capital from retained earnings year by year from 1952 through 1960, and over the course of nine years, an after tax increase each year averaging 15.30 per cent of original investment.

As trustee, Max J. Kuney, Jr. was not amenable to

the will of Max J. Kuney, Jr. as grantor (R. 276), nor was Max J. Kuney, Jr., as trustee, amenable to the will of Max J. Kuney, Sr. as grantor (R. 117), nor was either amenable to the will of the other in any capacity whatsoever. The Kuneys, as grantors and trustees, considered that strict observance of the trusts' regulations was very important. They were well aware that neither of them should feel required in any way to abide by the other's decisions in trust matters. In at least one important matter, the use of family partnership property in Seattle, Max J. Kuney, Jr. refused to follow the will of Max J. Kuney, Sr. because of the ill effect he thought it would have on the trust of which he was trustee (R. 277-278).

Changes in the income, retained earnings, and capital of all the partners for all years 1952 through 1956 were required by the acceptance of minor changes made by Internal Revenue Agent Francis A. Carney in rental charged by the partnership to the corporation in 1953 and 1954. When partnership income must be distributed in proportion to capital investment, a change in such income, even though it be for one year only, unavoidably results in changed income, income tax liability, retained earnings and capital for every year thereafter. The record in this case shows that income tax returns were amended and re-amended, and that books were corrected and re-corrected because of the strict observance of the rules governing family partnerships. The decision to confine the investment of trusts capital to fixed assets only, after June 1, 1953, was partially motivated by the fact that such a business arrangement would be applauded by the Internal Revenue Service.

At the inception, and prior to the official existence of Max J. Kuney Company Corporation, a stock certificate for 400,000 shares was printed in the name of "Max J. Kuney Company, General Partnership." This certificate was never issued nor recorded on the corporate books or elsewhere, but was canceled and left with the corporate records. Proper certificates issuing 200,000 shares ($200,000) each to Max J. Kuney, Sr. and Max J. Kuney, Jr. were issued and recorded in the corporate books under the official date of the formation of the Corporation, June 1, 1953.

Appellants' witness, James M. Henry, testified that he had written all the contract bonds for the Max J. Kuney Company partnership and the Max J. Kuney Company Corporation since 1940, and that he was advised that the trusts had become partners in the latter part of January, 1952. Appellants' witness, Edward A. Coon, testified that he had been Vice-President in charge of the Commercial Loan Department of the Seattle-First National Bank in Spokane and, as such, had handled all the loans made to the Kuney interests since 1950. He testified he was advised that the trusts had become partners in the early Spring of 1952, and stated that the annual financial statements regularly received from Max J. Kuney Company thereafter clearly revealed the existence of these trusts as partners of the family partnership. In their testimony witnesses Henry and Coon both stated that all contract bonds and all loans of Max J. Kuney Company had been made by the institutions which they represented, and that therefore all creditors were made aware of the existence of the trusts as partners in the Kuney family partnership.

The trust instruments, Federal and State gift tax returns, Federal and State income tax returns, and the financial statements of the Company, all of which were timely and properly filed, revealed the existence of the trusts as partners in the family partnership, and in some cases revealed the amount of their respective capital accounts (R. 198, 215).

Schedule A is a detailed analysis of partners' capital accounts showing correct distribution of income January 1, 1952, through December 31, 1958, computed in proportion to each partner's capital investment in the partnership, and as stipulated in the pre-trial order (R. 70). Schedule A, together with Schedules B and C, shows the actual performance of the trust partners and is presented as the best evidence in that respect. These schedules show a steady, consistent increase in trust capital from retained earnings year by year from 1952 through 1960, and over the course of nine years, an after tax increase each year averaging 15.30 per cent of the original investment.

Upon the District Court's instructions on the law and upon consideration of all facts and circumstances, the jury rendered verdicts that the status of Max J. Kuney, Sr. and Max J. Kuney, Jr., in their trustee capacities as partners in the Kuney family partnership, was genuine, bona fide and valid for income tax purposes.

In rendering its decision on the Appellees' motion for judgment notwithstanding the verdict of the jury, the court stated as follows:

> Under the portion of the charge to the jury reported at Pages 297 and 298 of the transcript,

to which no exception was taken by either plaintiffs or defendant, the matter of bona fides in the creation of the trust in question is the matter to be determined on the over-all showing presented by the evidence on consideration of the several specific factors referred to in the instructions:

1. Retention of controls, either direct or indirect by donor over income distributions, assets essential to partnership business, management powers, et cetera;

2. Indirect control exercised by the donor through either a separate business enterprise trust, et cetera;

3. Participation in the partnership by the donee. In this instance, of course, the trustee.

4. The manner of making partnership income distributions;

5. The actual manner in which the partnership business was conducted;

6. Control of business properties, assets, et cetera;

7. The reasonableness of salary and other compensation paid to the partners.

Conceding that in the record there is some evidence not inherently incredible which might support a fact finding favorable to plaintiffs on one or more of the facts referred to, it appears clear to me that a finding favorable to plaintiffs on the vital element pertaining to retention and exercise of control, referred to in two or three of the factors, is positively negatived by the evidence, and there is no evidence whatever to support the finding favorable to plaintiffs as to those elements. A finding adverse to plaintiffs as to a factor or two of only

> incidental importance might not and probably would not preclude a general verdict in favor of the plaintiffs as a matter of law. On the other hand, when a basic general issue must be determined in the light of findings on several factors of varying significance and importance, that now being established as the law of this particular case, and vital factors pertaining to the issue are negative and the Court has the clear and firm conviction that the evidence as a whole is not sufficient to sustain plaintiffs' affirmative burden of proof on that basic issue, it is the duty of the Court to set aside the verdict as not supported by substantial evidence and to grant a judgment for defendant notwithstanding the verdict.

The District Court agreed with the findings of the jury on all factors except numbers 1, 2 and 6 quoted above.

ARGUMENT

The Grantors Neither Retained Nor Exercised Controls Over the Trust Property Other Than Those Necessary to Managing Partners. The Controls Retained or Exercised by Appellants-Grantors Were Not of the Type or Degree to Allow the District Court to Reverse the Verdict of the Jury That the Trusts Were Genuine, Bona Fide and Valid Partners of the Kuney Family Partnership for Income Tax Purposes

An analysis of the evidence shows that the only testimony which could possibly have "positively negatived . . . a fact finding favorable to plainitffs" was the testimony of Harold V. Bowen.

Witness Bowen testified that the trustees have the power to distribute income from the trusts to the bene-

ficiaries "and by that discretion, they do directly control in a way what this percentage (44%) will be—" (R. 233, Court's Ex. 2). The District Court's comment at this point was "Well, that is the point, that is the question, they could if they chose to exercise it?" This comment (R. 233) indicated this must be the first of two or three vital elements of control referred to in the Court's decision.

The second element of control referred to by the District Court (R. 233-234) was in connection with witness Bowen's testimony that the adult Kuneys could take part or all of their $740,000.00 and invest it in fixed assets in the partnership so as to change "this percentage (56%)."

The third element of control referred to by the District Court (R. 239-240) was that the adult Kuneys "did control the sale and exchange of fixed assets—as dictated by business circumstances."

The first negative element found by the District Court (R. 233) is merely the power of the trustee to distribute trust income from the trust to the trust beneficiaries. This is a power of the trustee and not of the trust grantor. It is a perfectly legitimate, usual and necessary power for the trustee to have and to exercise.

The second negative element found by the District Court (R. 233-234) is the power of a partner to invest capital in the partnership. In this case, the power was no greater or less for one partner (trust grantor) than it was for the other (trustee). The power to determine total partnership investment was necessarily exercised by the managing partners (trust grantors). The amount

of capital invested by the trust partners from year to year was and is the amount of their retained earnings, and the amount of capital invested by the other partners was and is the amount required to equal the total partnership capital invested. The proportionate share of each partner's income was to be "as provided by the rules of law then effective for family partnerships" (Exhibits 24 and 25) and the percentage factor is a matter of simple arithmetic.

The third negative element (if there was a third) found by the District Court could only be that referred to at R. 239. This is merely the power to buy and sell partnership property common to all these partners. This power, necessarily exercised by the managing partners (trust grantors), is included in the second element and covered in the comments above.

The Supreme Court has advised that family partnership cases are essentially factual. *Commissioner of Internal Revenue v. Culbertson,* 337 U.S. 733. As such, previously decided cases are not particularly helpful, but it may be pertinent to note that there has never been a case where the decision has been against the trust grantors because of the type and degree of controls found by the District Court in the present case.

Appellee cited the "*Clifford* Case"* in its motion for judgment. In that case the trust provided for the corpus to revert to the grantor in five years, and permitted the grantor to not only control the income as trustee but to use it for his own support. These were the "elements of control" which decided that case against Clifford, the

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**Helvering v. Clifford,* 309 U.S. 331.

taxpayer trust grantor. In the present case no part of the trust corpus can ever revert to the grantor and no part of the trust income is under the control of the grantor and no part of it can be used for his support. The factual differences between the trusts in the present case and that in the *Clifford* case are so wide that need for any extended discussion is unnecessary.

In the case of *Commissioner v. Sultan,* 18 T.C. 715, the Court found that the trust corpus and income was to go to grantor's wife if the trust beneficiary died before reaching age 30, the trustee partner was required to obtain grantor's consent to trust investments during grantor's life, and was not allowed to transact partnership business nor incur partnership obligations, nor sell or dispose of trust property, nor withdraw from the partnership nor transact partnership business and incur partnership obligations. The trustee partner was compelled to retain his investment in the partnership unless the grantor permitted otherwise, and was thereby compelled to retain membership in a partnership in which he had no authority to transact partnership business. The degree of control found in the *Sultan* case is factually much greater than that found by the District Court in the present case. However, in the *Sultan* case it was held: "Grantor did not have any substantial control over, or interest in, the corpus or income—," and on this basis the Court decided in favor of the grantor taxpayer.

In the case of *Commissioner v. Stern,* 15 T.C. 521, the taxpayer was the general partner and four trusts for the benefit of his wife and three children were limited

partners. In that case the taxpayer-grantor was the trustee of the trusts that he created and "chose to use trusts rather than transfer the interests directly to his wife and children so that he could retain control over the business . . . ." On the matter of control which remained in the grantor in the *Stern* case, the Court said: "He retained entire control in himself but that is of no particular significance since limited partners normally have no part in the control or management of the business." On that basis the Court decided in favor of the grantor-taxpayer.

The House Ways and Means Committee Report (Section 340, Revenue Act of 1951) Appendix *infra* states:

> "Substantial powers may be retained by the transferor as a managing partner or in any other fiduciary capacity which, when considered in the light of all the circumstances, will not indicate any lack of true ownership in the transferee. In weighing the effect of the retention of any power upon the bona fides of a purported gift or sale, a power exercisable for the benefit of others must be distinguished from a power vested in the transferor for his own benefit."

In the present case we have independent trustees who were general partners well aware of their independence. The evidence shows they exercised their independence in at least one important matter. No part of the trust corpus can ever revert to the grantor nor to grantor's wife. No part of the trust income is under the control of the grantor, and no part of it can be used for his support or for the support of his wife. The trustee partners have unlimited authority over trust investments,

the partnership business and the partnership obligations. The trustees may withdraw from the partnership at any time and are not compelled to retain investments in the partnership. The trustees have the same management powers in the partnership as the grantors do and have complete control of the trusts. The grantors have retained no power whatsoever over the trusts which they created. *The most that can be made out of controls retained by grantors of trusts in family partnership cases is that they are tests of good faith, but only tests. Where good faith really and truly exists, no degree of control can change that fact.*

CONCLUSION

The District Court erred in concluding that the trust grantors held or exercised any controls over the trust property other than those necessary to managing partners. The powers retained by the transferors, when considered in the light of all the circumstances, do not indicate any lack of true ownership in the transferees.

The verdict of the jury should be upheld and the decision of the District Court should be reversed.

Respectfully submitted,

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APPENDIX

APPENDIX

Internal Revenue Code of 1939:

Sec. 167. Income for Benefit of Grantor.

(a) Where any part of the income of a trust—

(1) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, held or accumulated for future distribution to the grantor; or

(2) may, in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income, be distributed to the grantor; or

(3) is, or in the discretion of the grantor or of any person not having a substantial adverse interest in the disposition of such part of the income may be, applied to the payment of premiums upon policies of insurance on the life of the grantor (except policies of insurance irrevocably payable for the purposes and in the manner specified in section 23(o), relating to the so-called "charitable contribution" deduction);

then such part of the income of the trust shall be included in computing the net income of the grantor.

Sec. 191. Family Partnerships.

In case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the

share of the donor attributable to the donor's capital. The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service. For the purpose of this section, an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The "family" of any individual shall include only his spouse, ancestors, and lineal descendants, and any trust for the primary benefit of such persons.

(As added by Section 340 of the Revenue Act of 1951.)

Internal Revenue Code of 1954:

Sec. 704. Partner's Distributive Share.
(e) Family Partnerships.

(1) Recognition of Interest Created by Purchase or Gift. A person shall be recognized as a partner for purposes of this subtitle if he owns a capital interest in a partnership in which capital is a material income-producing factor, whether or not such interest was derived by purchase or gift from any other person.

(2) Distributive Share of Donee Includible in Gross Income. In the case of any partnership interest created by gift, the distributive share of the donee under the partnership agreement shall be includible in his gross income, except to the extent that such share is determined without allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the portion of such share attributable to donated capital is proportionately greater than the share of the donor attributable to the donor's capital. The distributive share of a partner in the earnings of the partnership shall not be diminished because of absence due to military service.

(3) Purchase of Interest by Member of Family. For purposes of this section, an interest purchased by one member of a family from another shall be considered to be created by gift from the seller, and the fair market value of the purchased interest shall be considered to be donated capital. The "family" of any individual shall include only his spouse, ancestors, and lineal descendants, and any trusts for the primary benefit of such persons.

Committee Report:

House Ways and Means Committee Report. [Section 340, Revenue Act of 1951] is intended to harmonize the rules governing interests in the so-called family partnership with those generally applicable to other forms of property or business. Two principles governing attribution of income have long been accepted as basic: (1) income from property is attributable to the owner of the property; (2) income from personal services is attributable to the person rendering the services. There is no reason for applying different principles to partnership income. If an individual makes a bona fide gift of real estate, or of a share of corporate stock, the rent or dividend income in taxable to the donee. Your committee's amendment makes it clear that, however the owner of a partnership interest may have acquired such interest, the income is taxable to the owner, if he is the real owner. If the ownership is real, it does not matter what motivated the transfer to him or whether the business benefited from the entrance of the new partner.

Although there is no basis under existing statutes for any different treatment of partnership interests, some decisions in this field have ignored the principle that income from property is to be taxed to the owner of the property. Many court decisions since the decision of the Supreme Court in *Commissioner v. Culbertson* (337

U.S. 733 [49-1 USTC ¶ 9323]), have held invalid for tax purposes family partnerships which arose by virtue of a gift of a partnership interest from one member of a family to another, where the donee performed no vital services for the partnership. Some of these cases apparently proceed upon the theory that a partnership cannot be valid for tax purposes unless the intrafamily gift of capital is motivated by a desire to benefit the partnership business. Others seem to assume that a gift of a partnership interest is not complete because the donor contemplates the continued participation in the business of the donated capital. However, the frequency with which the Tax Court, since the *Culbertson* decision, has held invalid family partnerships based upon donations of capital, would seem to indicate that, although the opinions often refer to "intention," "business purpose," "reality," and "control," they have in practical effect reached results which suggest that an intrafamily gift of a partnership interest, where the donee performs no substantial services, will not usually be the basis of a valid partnership for tax purposes. We are informed that the settlement of many cases in the field is being held up by the reliance of the field offices of the Bureau of Internal Revenue upon some such theory. Whether or not the opinion of the Supreme Court in *Commissioner v. Tower* (327 U.S. 280 [46-1 USTC ¶ 9189]), and the opinion of the Supreme Court in *Commissioner v. Culbertson* (337 U.S. 733 [49-1 USTC ¶ 9323]), which attempted to explain the *Tower* decision, afford any justification for the confusion is not material—the confusion exists.

The amendment leaves the Commissioner and the courts free to inquire in any case whether the donee or purchaser actually owns the interest in the partnership which the transferor purports to have given or sold him. Cases will arise where the gift or sale is a mere

sham. Other cases will arise where the transferor retains so many of the incidents of ownership that he will continue to be recognized as a substantial owner of the interest which he purports to have given away, as was held by the Supreme Court in an analogous trust situation involved in the case of *Helvering v. Clifford* (309 U.S. 351 [40-1 USTC ¶ 9265]. The same standards apply in determining the bona fides of alleged family partnerships as in determining the bona fides of other transactions between family members. Transactions between persons in a close family group, whether or not involving partnership interests, afford much opportunity for deception and should be subject to close scrutiny. All the facts and circumstances at the time of the purported gift and during the periods preceding and following it may be taken into consideration in determining the bona fides or lack of bona fides of a purported gift or sale.

Not every restriction upon the complete and unfettered control by the donee of the property donated will be indicative of sham in the transaction. Contractual restrictions may be of the character incident to the normal relationships among partners. Substantial powers may be retained by the transferor as a managing partner or in any other fiduciary capacity which, when considered in the light of all the circumstances, will not indicate any lack of true ownership in the transferee. In weighing the effect of a retention of any power upon the bona fides of a purported gift or sale, a power exercisable for the benefit of others must be distinguished from a power vested in the transferor for his own benefit.

Since legislation is now necessary to make clear the fundamental principle that, where there is a real transfer of ownership, a gift of a family partnership interest is to be respected for tax purposes without regard to

the motives which actuated the transfer, it is considered appropriate at the same time to provide specific safeguards—whether or not such safeguards may be inherent in the general rule—against the use of the partnership device to accomplish the deflection of income from the real owner.

Therefore the bill provides that in the case of any partnership interest created by gift the allocation of income according to the terms of the partnership agreement shall be controlling for income tax purposes except when the shares are allocated without proper allowance of reasonable compensation for services rendered to the partnership by the donor, and except to the extent that the allocation to the donated capital is proportionately greater than that attributable to the donor's capital. In such cases a reasonable allowance will be made for the services rendered by the partners, and the balance of the income will be allocated according to the amount of capital which the several partners have invested. However, the distributive share of a partner in the earnings of the partnership will not be diminished because of absence due to military service.

When more than one member of a family is a member of a partnership all interests purchased by one member of the family from another will be treated as though the transfer were made by gift. For this purpose the family of an individual includes his spouse, ancestors, lineal descendants, and any trust for the primary benefit of such persons.

Section 340 applies to taxable years beginning after December 31, 1950. No inferences are to be drawn from its enactment with respect to taxable years beginning prior to January 1, 1951.

HOUSE WAYS AND MEANS COMMITTEE REPORT ON REVENUE BILL OF 1951.